

Avoiding collateral damage

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Over the last few months I have been approached by a number of Sub-Contractors asking the same question, “Why do I need to sign up to this collateral warranty”? This is usually followed up with “Oh, and what exactly is a collateral warranty”? This is a problem I see time and again, and stems from a real lack of understanding of what a collateral warranty really is.

Most of our subbie clients face the same dilemma; works are underway in the project when out of the blue, the Contractor turns up with a collateral warranty and demands that the Sub-Contractor signs it as soon as possible. More often than not, the collateral warranty is signed and the Sub-Contractor has unknowingly extended his obligations in the project.

The aim of this article is to shed some light on what collateral warranties actually are and to help you understand what you are exactly signing up to.

What is a collateral warranty?

Professionals involved in the construction industry are aware of the traditional contractual relationship which exists in most construction projects. The Employer has a contract in place with the Contractor and the Contractor in turn, with any Sub-Contractors. This structure however, leaves the Employer with no direct contractual relationship with the Sub-Contractor, which could result in a number of issues during and after the construction process.

A collateral warranty can fix this issue. There are different variations of collateral warranties but in essence, it is the contract between a:

- a) Third party, such as a Purchaser, Tenant or Funder with an interest in the project (“*the Beneficiary*”) and a
- b) Contractor, Consultant or Sub-Contractor (“*the Warrantor*”)

working on a construction project. The collateral warranty provides the Beneficiary the right to rely on representations and warranties given by the Warrantor, and have a means of recourse against the Warrantor if there is an issue with the work.

Why do Beneficiaries want a collateral warranty?

The main reason is because the Beneficiary wishes to have a direct contractual relationship in place with the Warrantor. This would prove to be extremely useful in instances where the Contractor becomes insolvent for example, which leaves the Beneficiary with no direct contractual link from which to seek damages from the Sub-Contractor. The Beneficiary could find himself with a half built project with no way to complete it with the existing Sub-Contractor as he has no contractual right to issue work or provide payment. The doctrine of privity, a legal principle which allows a contract to only confer rights and impose liabilities on its contracting parties, prevents the Beneficiary from using the Agreement between the Contractor and Sub-Contractor as a means of redress. The Beneficiary is further likely to face challenges in bringing forth claim damages in tort against the Sub-Contractor because of restrictions placed under the recovery of pure economic loss. This is where collateral warranties can be effective.

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What are the advantages?

The main advantage of having a [collateral warranty](#) in place is to create a direct contractual relationship between the Beneficiary and the Warrantor. Also, depending on the wording and timing of the warranty, the warranty could also be considered to be a construction contract and thus could be subjected to adjudication under the Housing Grants, Construction and Regeneration Act 1996 for England and Wales and the Construction Contracts (Northern Ireland) Order 1997 for Northern Ireland.

There have been remarkably few legal disputes involving collateral warranties to date. The *Scottish Widows Services -v- Building Design Partnership (2012)* demonstrated to practitioners that it would be difficult for a Contractor or Consultant to argue that a party who has the benefit of a warranty is not entitled to bring forth a claim for losses caused by defects.

Current mentality on collateral warranties

It is alarming how often we discover that professionals are unaware of what collateral warranties actually are, why they are needed (if at all) and what they should or should not entail. A Warrantor should remember that whilst a collateral warranty might extend the number of parties who he might be “*at risk*”, it should not extend his level of risk. Furthermore, the strength of a collateral warranty is only as strong as its underlying contract (main contract or sub-contract) from which it has derived.

Tips

So, here are some pointers on what you should be looking for, before signing a collateral warranty.

The first question a Warrantor should ask is, “*Am I obliged to provide one?*”. Whilst it is common place for building contracts or appointments to include express obligations for the provision of collateral warranties, this is not always the case. By providing a collateral warranty that did not have to be provided, the Warrantor is merely exposing himself to risk that he might not necessarily be required to. Quite often, we will see “requests” for warranties to be provided late in the day. A request might not be an obligation so always think before just giving.

The Warrantor should also ensure that the collateral warranty does not extend his liability and contractual obligations. If, for example, the scope of the works extends only to construction, ensure that the collateral warranty does not seek to impose responsibility for somebody else’s design obligations.

The Warrantor can ensure that he is safeguarded in a collateral warranty through the inclusion of a number of provisions. One such provision is the “*no greater liability*” clause. This sets out that the Warrantor cannot owe the Beneficiary a greater duty than it would owe under its appointment with the Employer.

The Warrantor can also benefit from the inclusion of a Net Contribution Clause. This type of clause can help dilute the Warrantor’s liability such that the Warrantor’s liability can be limited to an amount that is fairly and reasonably attributable to its level of culpability. The Warrantor can also seek that there is a liability cap in the collateral warranty, perhaps both in time for taking claims and monetary level of exposure.

Aside from the above provisions which the Warrantor can use to his advantage, the Beneficiary can also include provisions which would be rather common in collateral warranties. One such provision is the Step In Rights which provides a right for the Beneficiary to step in place of the Employer/Contractor in a project. This provides some security that the project will continue despite the removal of such party.



Don't forget!

As stated earlier, the collateral warranty is a child of the underlying contract so be aware of the contractual provisions dealing with them at the outset. Quite often their provision can be made a pre-condition to payment or more worryingly, cleverly drafted enduring power of attorney provisions can afford Employers to effectively execute them on your behalf. This should be avoided at all costs.

Final thoughts

Arranging and understanding collateral warranties can be hugely time consuming. Many involved in the construction industry are not fans of collateral warranties due to this reason. However, for Beneficiaries who are spending money and resources for such projects, a collateral warranty could prove to be extremely valuable if executed properly and are likely to be around for some time to come.

This is only a concise overview of the background and nature of collateral warranties, but hopefully this article would have given you a deeper insight of what they really are. If you're in a situation where you are not certain about a collateral warranty that has been handed over to you, don't be afraid to give Kenny Caldwell or Lahiru Elvitigala a call about it. Quigg Golden are specialists on deciphering collateral warranties and we will highlight the risks (and possibly additional obligations) for signing such a collateral warranty.



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